PCAOB
Public Company Accounting Oversight Board

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April 1, 2004

The Honorable Edward J. Markey
U.S. House of Representatives
2108 Rayburn House Office Building
Washington, D.C. 20515-2107

Dear Congressman Markey:

Thank you for your letter of February 23, 2004 concerning the practice of tax preparers and accountants outsourcing tax preparation to workers outside the United States. I share your concern that public accounting firms outsourcing of this work not compromise the quality of their work or infringe upon their clients' legitimate privacy interests.

While the PCAOB's statutory responsibility is to oversee the audit of public companies and to further the preparation of informative, accurate and independent audit reports on the financial statements of public companies, I believe that public accounting firms will only regain the confidence of the American people by rededicating themselves to acting in accordance with the highest professional standards in all aspects of their practice. Without doubt, adhering to such standards requires ensuring their clients that work will be performed in a competent manner by experienced professionals and that individuals' legitimate privacy interests are respected. I have asked the PCAOB's Office of the Chief Auditor and Office of General Counsel to answer the specific questions in your letter directed to the PCAOB. I am enclosing a copy of their responses.

I hope that you will find the attached information helpful. If I can be of further assistance, please do not hesitate to contact me.

Sincerely,

William J. McDonough
Chairman

Attachment

cc: The Honorable Mark W. Everson
Commissioner, Internal Revenue Service

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Memorandum

To: Chairman William J. McDonough

From: Lewis H. Ferguson, III
General Counsel

Douglas R. Carmichael
Chief Auditor

Re: February 23, 2004 Letter from Congressman Edward J. Markey

Date: April 1, 2004

You have asked us to respond to the six questions directed to the Public Company Accounting Oversight Board ("PCAOB" or the "Board") in Congressman Edward J. Markey's February 23, 2004 letter concerning the practice of outsourcing tax preparation to workers located in foreign countries. Our responses to the questions appear below.

At the outset, we should note that, under the Sarbanes-Oxley Act of 2002 (the "Act"), the PCAOB's mission is to "oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." In keeping with this mission, neither the Sarbanes-Oxley Act, nor the Board's rules and standards, address the preparation of tax returns per se. Nonetheless, many of the registered public accounting firms subject to the Board's oversight provide tax services, as well as audit services. Moreover, many of these firms, as permitted by the Sarbanes-Oxley Act and the rules of the Securities and Exchange Commission ("SEC" or the "Commission") thereunder, provide tax services to their audit clients.[1] Accordingly, the PCAOB staff has been monitoring this issue and

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[1] These services, like all non-audit services above a de minimis threshold provided to an audit client, must be pre-approved by the audit client's audit committee. Securities Exchange Act of 1934, Section 10A(h), 15 U.S.C. 78j-1(h).

will be vigilant to the development of similar practices in firms' public company auditing practices.

* * *

1. Is there any requirement in the federal tax laws and regulations, or in the rules governing the business conduct of accountants employed by public companies, which require such accountants or other professional tax preparers to disclose to their clients that the preparation or analysis of their tax return is being outsourced to an offshore person or entity? If not, do you believe that such explicit notice should be required?

2. Is there any requirement in the federal tax laws or regulations, or in the rules governing the business conduct of accountants serving public companies, that would require and accountant or other professional tax prepare to obtain the express written consent of the tax payer before a tax return or related personal information could be outsourced to an overseas entity or person? Do you believe such explicit notice should be required?

Response to Questions 1-2:

Our understanding is that the existing professional requirements do not currently require accountants to disclose to their clients the outsourcing of work to a foreign entity or to obtain their clients' prior express written consent to outsource to such entities.[2] We further understand that the Professional Ethics Executive Committee ("PEEC") of the American Institute of Certified Public Accountants ("AICPA") has recently formed a task force to study whether the existing professional standards should be strengthened in these areas. We agree that this is a timely and important issue for the PEEC to address, and we will monitor the work of their task force.

We also understand that the privacy provisions of the Gramm-Leach-Bliley Act of 1999 may apply in these situations. Title V of that Act contains consumer protections related to the use and disclosure of personal financial information. In particular, the Gramm-Leach-Bliley Act creates a requirement for certain financial service providers to provide their customers with notice of, and the ability to opt-out of, the sharing of personal financial information with unaffiliated third parties. While the PCAOB does not administer these provisions, our understanding is that these provisions may apply in the context of an accountant or tax preparer's work on an individual's tax return.[3]

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[2] See Richard I. Miller and Alan W. Anderson, "Legal and Ethical Considerations Regarding Outsourcing," Journal of Accountancy, at 33 (March 2004) ("Miller and Anderson").

[3] These provisions are primarily administered by the Federal Trade Commission. The FTC may be able to provide further information concerning the application of this Act and its implementing regulations in this context.

* * *

3. The aforementioned press report indicates that some firms have established security procedures to help ensure that any foreign workers employed in the processing or analysis of a tax return. It is also reported that other firms have no such procedures in place and instead may merely email a taxpayer's information to an offshore entity or person for processing. Have either of your agencies reviewed the security policies and procedures used by accounting firms or other tax preparers to assure their adequacy? Is there any penalty for not having such procedures, or for failing to implement them properly?

Response to Question 3:

As noted above, the Board's authority to inspect registered public accounting firms centers on those firms' work in preparing and issuing audit reports for public companies. Accordingly, we have not reviewed or assessed the adequacy of the security policies and procedures used by accounting firms or other tax preparers to transmit tax return information.

Congressman Markey's question also asks about the legal and disciplinary ramifications of not having such procedures or not implementing them properly. Accountants that are members of the AICPA must comply with that organization's Code of Professional Conduct, which specifically requires members in public practice to "not disclose any confidential client information without the specific consent of the client." AICPA Code of Professional Conduct, Rule 301, Confidential Client Information, ET Section 301.01.

The AICPA has promulgated an ethics ruling applying this rule in the context of the use of an outside party to process a client's tax return.[4] That ruling states that an AICPA member may utilize a third party to process tax returns, but that the member "must take all necessary precautions to be sure that the use of outside services does not result in the release of confidential client information." AICPA Ethics Rule No. 1, under the Code of Professional Conduct Rule 301, Computer Processing of Client Returns, ET Section 391.001-.002. As reflected in the response to Questions 1 and 2 above, we understand that the AICPA's PEEC is currently evaluating whether applicable professional standards in this area, including this ruling, should be strengthened.[5] Violation of a provision of the AICPA's Code of Professional Conduct subjects the member to an array of disciplinary measures, up to and including expulsion from the AICPA.

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4 Miller and Anderson, at 31-32.

5 Id. at 32.

4. If a person or company engages an accounting firm to prepare their taxes or provides them with tax advice, and then that accounting firm outsources this work to an offshore person or entity, isn't there a risk that the person doing the work may not be knowledgeable about the U.S. tax laws and regulations, or may not have the skills and training of a U.S. CPA? Are you concerned that individuals or companies may be misled into believing that their tax returns are being prepared or analyzed by a CPA, when in fact they are not? Is there any penalty for making such a misrepresentation? If no, should there be?

Response to Question 4:

We appreciate the concern that an accounting firm that outsources tax work to an offshore entity creates a risk that the person doing the work may not be knowledgeable about the U.S. tax laws or have the skills and training of a CPA. Under the existing professional standards, accountants that are members of the AICPA must perform all professional services with due professional care and must only undertake those professional services they can reasonably expect to complete with professional competence. AICPA Code of Professional Conduct, Rule 201, General Standards, ET Section 201.01. The profession has interpreted this Rule to require an accountant who uses a subcontractor to perform professional services to ensure that the subcontractor has the professional qualifications, technical skills and other resources required to perform the professional services. See AICPA Ethics Rulings on General and Technical Standards No. 8, Subcontractor Selection for Management Consulting Service Engagements, ET Section 291.015-.016. Apart from the professional standards, application of basic principles of agency law may provide that the principal would be bound by the actions of the subcontractor. See, generally, Restatement (Second) of Agency, Section 2 (1958).

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5. [For the PCAOB] It is my understanding that the PCAOB's has oversight and enforcement authority over accounting firms serving as auditors of public companies. I further understand that the Sarbanes-Oxley Act allows such auditors to perform certain tax services for public companies (if approved by the companies' audit committee). If an PCAOB-regulated auditor outsourced the preparation of tax returns for or the provision of tax advice or tax counseling for a public company, what authority would the PCAOB have over the offshore entity? In your response, please address the case of an offshore affiliate of a registered auditor and the case of an unaffiliated third party acting as a subcontractor of an auditing firm.

Response to Question 5:

In general, the Board's authority extends to both the public accounting firms engaged in auditing public companies and, in the Act's phrase, the "associated persons" of such firms. "Person associated with a public accounting firm" is defined in both the

Act and the Board's rules to include any individual or independent contractor that, in connection with the preparation or issuance of an audit report –

(1) shares in the profits of, or receives compensation in any other form from, that firm; or

(2) participates as agent on behalf of such accounting firm in any activity of that firm.

Act, Section 2(a)(9); PCAOB Rule 1001(p)(ii). The Board has clarified that this definition applies to entities that meet the statutory test, whether in the United States or not and whether considered an "affiliate" of the registered public accounting firm or not.[6]

It is important to note, however, that the Board's authority generally relates to the work of registered public accounting firms and their associated persons on matters related to the preparation or issuance of audit reports for public companies. To the extent the tax work does not relate to the preparation or issuance of an audit report, responsibility for overseeing that work rests with other organizations.

* * *

6. [For the PCAOB] It is my understanding that the PCAOB has authority under Section 201 of the Sarbanes-Oxley Act to declare, by regulation, certain other non-audit services to be impermissible to be conducted by a registered auditor of a public company. Has the PCAOB considered whether offshoring of tax or certain other non-audit services by an auditor should be subject to further regulation or even prohibition in order to ensure privacy, confidentiality, data security, and facilitate effective law enforcement over such auditors? If so, what action have you taken? If not, why not?

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[6] The Board has addressed some of these questions in its Frequently Asked Questions Regarding Registration with the Board, PCAOB Rel. No. 2003-011A (updated November 13, 2003). For example, see FAQ 23 ("23: My firm uses an outside accounting firm as an independent contractor on certain audit engagements. Is the outside firm considered an associated person of my firm? . . . .Board rules define "person associated with a public accounting firm" to include independent contractors, so the outside firm you use on audits will be considered an associated person if it otherwise meets the definition in the rule. . . . . "); and FAQ 25 ("25. If my firm employs an accountant from another country on a temporary basis, does it have to list that accountant as an associated person in Part VII of Form 1? Yes, if the accountant meets the definition of a person associated with the firm and provided at least 10 hours of audit services for any issuer during the last calendar year. The fact that an accountant is from another country is irrelevant.").

Response to Question 6:

Under Section 103(b) of the Act, the Board is authorized to establish standards of auditor independence. In addition to this general standards-setting authority, Section 201 of the Act expressly authorizes the Board to adopt regulations specifying non-audit services - in addition to those specified in the Act - that may not be provided to audit clients.

As directed by the Act, the SEC adopted new independence rules in order to implement Title II of the Act. These rules, which became effective in May 2003, address key aspects of auditor independence with special emphasis on the provision of non-audit services. Consistent with Section 201 of the Act, the rules expressly prohibit ten categories of non-audit services. The SEC's rules also implement the Act's requirement, in Section 202, that all audit and non-audit services be preapproved by the company's audit committee.

Neither the Act nor the SEC's rules prohibit tax services that are preapproved by the company's audit committee (unless, of course, those services also fall into one of the categories of expressly prohibited services). Rather, the Act expressly recognized that accountants "may engage in any non-audit services, including tax services," that do not fall into one of the prohibited categories, provided that each service is approved in advance by the audit committee. The SEC's adopting release on its new rules noted that there had been considerable debate regarding whether an accountant's provision of tax services for an audit client could impair the auditor's independence. The SEC determined not to prohibit tax services, however, in part because audit firms - both large and small - have long played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities. Thus, the SEC "reiterated its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence * * * [and] may continue to provide tax services such as tax compliance, tax planning, and tax advice, to audit clients, subject to normal audit committee pre-approval requirements * * * *."

The Board has not yet exercised its authority to prohibit the provision of additional types of non-audit services to audit clients. The purpose of this authority is to avoid the provision of types of services that may be inconsistent with the auditor maintaining its independence from their audit clients. Moreover, the Board's authority to prohibit a registered firm from providing certain non-audit services is restricted to limiting the services that a registered firm may provide to an audit client, and the Board cannot directly prohibit a registered firm from selling services to non-audit clients. Nor can the Board prohibit the non-audit services public accounting firms provide to any non-public company. Accordingly, issues such as the competence of the accountant providing the non-audit service and procedures for ensuring the confidentiality of client information in providing the non-audit service will remain subjects to be addressed by those bodies that set the general professional standards applicable to the accounting profession.

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We hope that this information will be useful. Of course, we would be glad to respond to any further questions Congressman Markey or his staff may have.